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No. __-_____

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1995

WHEREHOUSE ENTERTAINMENT, INC.; LOUIS A. KWIKER; GEORGE A. SMITH; MICHAEL T. O'KANE; LAWRENCE K. HARRIS; DONALD E. MARTIN; JOEL D. TAUBER; FURMAN SELZ MAGER DIETZ & BIRNEY, INC.; WEI ACQUISITION CORP.; WEI HOLDINGS, INC.; and ADLER & SHAYKIN,

Petitioners,

—v.—

MCMAHAN & COMPANY; FROLEY, REVY INVESTMENT CO., INC.; WECHSLER & KRUMHOLZ, INC.; and DON THOMPSON, on behalf of himself and all others similarly situated,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Are plaintiffs who assert a claim under Section 10(b) of the Securities Exchange Act of 1934 required to prove that their loss was caused by the defendants' alleged misrepresentations?

2. Are plaintiffs who assert a claim under Section 10(b) of the Securities Exchange Act of 1934 limited to a recovery of their out-of-pocket losses or may they recover a contractual expectation-based measure of damages?

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PETITION FOR A WRIT OF CERTIORARI

Petitioners respectfully request the issuance of a writ of certiorari to review a decision of the United States Court of Appeals for the Second Circuit in this case.

OPINIONS BELOW

The Opinion of the United States Court of Appeals (Appendix ("App."), *infra*, 1a-17a) for the Second Circuit is reported at 65 F.3d 1044 (2d Cir. 1995). The District Court's August 12, 1994 opinion (App., *infra*, 22a-47a) is reported at 859 F. Supp. 743 (S.D.N.Y. 1994). The District Court's December 21, 1995 opinion (App., *infra*, 18a-21a) is unreported.

JURISDICTION

The Court of Appeals rendered its decision on September 13, 1995. App., *infra*, 1a-17a. A petition for a rehearing was denied on December 15, 1995. App., *infra*, 61a-62a. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

Jurisdiction of the United States District Court for the Southern District of New York was based on Section 27 of the Securities Exchange Act of 1934 (the "Exchange Act") (15 U.S.C. § 78aa), Section 22 of the Securities Act of 1933 (the "Securities Act") (15 U.S.C. § 77v), Section 1331 of Title 28 (28 U.S.C. § 1331) (federal question jurisdiction) and principles of supplemental jurisdiction (28 U.S.C. § 1367).[1]

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[1] This Court often has exercised its discretion to review, on petition for writ of certiorari, decisions of the Circuit Courts of Appeal resolving questions certified for interlocutory appeal pursuant to 28 U.S.C. § 1292(b). *See, e.g., Yamaha Motor Corp., U.S.A.* v. *Calhoun*, 116 S. Ct. 619 (1996); *Finley* v. *United States*, 490 U.S. 545 (1989); *Chan* v. *Korean Air Lines, Ltd.*, 490 U.S. 122 (1989).

STATEMENT OF THE CASE

This action arises out of the issuance of 6-1/4% Convertible Subordinated Debentures (the "Debentures") by Wherehouse Entertainment, Inc. ("Wherehouse"). The Indenture for these Debentures contains a "poison put" provision (the "Poison Put") that allows a debentureholder to require Wherehouse to repurchase the Debentures at a premium in the event of a change in control that is *not* approved by a majority of Wherehouse's non-management directors (the "Independent Directors"). App., *infra*, 24a. The Debentures were issued pursuant to a prospectus (the "Prospectus") which quoted verbatim the Indenture's description of the Poison Put. App., *infra*, 140a-141a, 146a-147a; J.A. 293-94.[2]

When Wherehouse issued the Debentures in July of 1986, they traded on the American Stock Exchange at approximately 100% of their par value. In the ensuing sixteen months, Wherehouse's financial problems and the stock market crash of October 1987 caused the trading price of the Debentures to plummet by over 40%. App., *infra*, 20a; J.A. 144-47, 299-306, 405, 458, 542-62. Plaintiffs purchased virtually all of their Debentures in the secondary market at substantial discounts to the face value and offering price of the Debentures in order to take advantage of their effective interest yield of almost 12%. J.A. 412.

In November of 1987, Shamrock Holdings commenced a hostile tender offer for Wherehouse's common stock. At that time, the Debentures traded at a steep discount of approximately $480 to $510 for each $1000 Debenture. App., *infra*, 5, 20a; J.A. 306. After soliciting competing offers for the company, Wherehouse, with the support of its Independent Directors, entered into a merger agreement with an affiliate of Adler & Shaykin, WEI Holdings, Inc. ("WEI"). Upon the announcement of the merger (the "Merger") on December 21,

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[2] All references to "J.A. ___" are to the Joint Appendix filed with the United States Court of Appeals for the Second Circuit.

1987, the price of the Debentures increased from $470 to $490. App., *infra*, 5a; J.A. 306, 773-76.

On December 23, 1987 Wherehouse filed with the Securities and Exchange Commission and disseminated to its shareholders a letter and attached Schedule 14D-9 recommending that shareholders tender their shares to WEI (the first step leading to the Merger), and disclosing that debentureholders "will not be able to exercise the Put Right in connection with the" Merger. J.A. 773, 839. Following this announcement, the price of the Debentures actually increased to $500. App., *infra*, 4a-5a; J.A. 306.

Plaintiffs commenced these actions in January 1988, claiming that Wherehouse breached the terms of the Indenture by not allowing debentureholders to exercise the Poison Put and tender their Debentures back to Wherehouse at a premium of $1,062.50 per Debenture. (This claim cannot be squared with the plain language of the Indenture, quoted in the Prospectus, which provides that where a merger is approved by the company's Independent Directors, the Poison Put cannot be exercised). In the alternative, plaintiffs alleged that if they did not have a contractual right to exercise the Poison Put, defendants violated the federal securities laws by misrepresenting as "valuable" an "illusory" right to exercise the Poison Put upon a change in control of Wherehouse, and that Wherehouse "encouraged the inference that exercise of the right would be the norm." App., *infra*, 90a.[3]

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[3] Defendants moved to dismiss plaintiffs' complaints for failure to state a claim upon which relief may be granted. In an Opinion and Order dated May 22, 1989 (App., *infra*, 100a-112a), the District Court granted summary judgment for defendants, holding that (1) the Prospectus disclosed, virtually verbatim, all pertinent provisions of the Indenture, and (2) no triggering event giving rise to a right to tender occurred because the Merger was approved by a majority of the Independent Directors. *Id.*

On April 10, 1990, a divided panel of the Second Circuit Court of Appeals reversed the decision of the District Court. App., *infra*, 82a-96a. This Court denied defendants' petition for certiorari on June 28, 1991. App., *infra*, 81a.

After the conclusion of discovery, defendants moved for summary judgment on plaintiffs' federal securities law claims because the facts established—and plaintiffs conceded—that alleged misrepresentations about the Poison Put did not inflate the market price of the Debentures. App., *infra*, 19a-20a, 35a; J.A. 150-58. In fact, immediately prior to the announcement of the Merger, the Debentures were trading at $470 per Debenture. When approval of the Merger was announced on December 21, 1987 and plaintiffs claim to have learned for the first time that the Poison Put would not be triggered, the market price of the Debentures actually *increased*, not decreased. App., *infra*, 4a-5a, 20a; J.A. 306, 773. Section 11 of the Securities Act provides no recovery where, as here, defendants prove that "the depreciation in value [of plaintiffs' securities] resulted from factors other than the material misstatement in the registration statement." *Akerman* v. *Oryx Communications*, 810 F.2d 336, 340 (2d Cir. 1987), citing 15 U.S.C. § 77k(e). Damages cannot be recovered under Section 10(b) of the Exchange Act (15 U.S.C. § 78j(b)) where the value of the securities declines *before* corrective disclosure because such losses could not possibly have been caused by the as-yet-undiscovered fraud.

In an opinion and order dated August 12, 1994 (the "August 12 Order") the District Court held that the absence of loss causation in this case was "irrelevant." App., *infra*, 36a. In order not to render the securities laws "toothless" (App., *infra*, 36a), the District Court impermissibly substituted common law breach of contract remedies (*i.e.*, loss of "*promised value*" or "benefit-of-the-bargain" damages) (App., *infra*, 36a) for the specific remedies enumerated in the Securities Act and for the judicially created remedies under Section 10(b) of the Exchange Act.

Defendants requested that the District Court certify the foregoing rulings for an immediate interlocutory appeal. On October 13, 1994 and January 3, 1995 the District Court and

the Second Circuit respectively certified these rulings pursuant to 28 U.S.C. § 1292(b).[4] App., *infra*, 63a-69a.

The Second Circuit reversed the District Court's ruling that benefit-of-the-bargain damages are recoverable under Section 11 of the Securities Act and correctly held that:

> [W]here a defendant proves that the decline in the value of the security in question was not caused by the material omissions or misstatements . . . plaintiff is not entitled to recover any damages. Here, the district court erred in ruling that plaintiffs may recover benefit-of-the-bargain damages under section 11 and that the market value was 'irrelevant to plaintiffs' claimed economic losses.'[5]

With respect to plaintiffs' Section 10(b) claim under the Exchange Act, the Court of Appeals incorrectly concluded that plaintiffs' claim under Section 10(b) of the Exchange Act "stands on a different footing" and that plaintiffs could seek to recover benefit-of-the-bargain damages—a windfall of approximately twice the amount they paid for their securities.

The Court of Appeals, however, failed to address any of the decisions of other Circuits, *see* Point I, *infra*, holding that the same evidence which required the dismissal of plaintiffs' Section 11 claim—the absence of any causal connection between the alleged misrepresentation and the allegedly inflated mar-

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[4] On November 14, 1994, the District Court issued an order (App., *infra*, 66a-68a) identifying the precise ruling which had been certified for appeal:

> "[Whether] plaintiffs are entitled to recover damages under [the federal securities laws] under a benefit-of-the-bargain theory . . . regardless of whether the misrepresentation alleged affected the market value of plaintiffs' securities."

[5] On remand, the District Court dismissed plaintiffs' Section 11 claim.

ket price of their securities—also forecloses any recovery under Section 10(b) of the Exchange Act as a matter of law.

The Second Circuit's Opinion also is contrary to universal precedent in this Court and several other Circuit Courts of Appeal holding that allegedly defrauded purchasers of securities are limited to a recovery of their out-of-pocket losses under Section 10(b) of the Exchange Act. Unless the decision is reversed, corporate directors, underwriters and issuers will be exposed to liability for the anticipated or wished for trading profits of investors that were never obtained because of general market conditions and economic factors that are wholly unrelated to the alleged securities law violation.

REASONS FOR GRANTING THE PETITION

The District Court and the Second Circuit both found that the loss causation and damage issues in this litigation are "controlling question[s] of law as to which there is substantial grounds for difference of opinion." App., *infra*, 63a-65a, 67a. Indeed, there is considerable confusion and inconsistency among the Circuit Courts of Appeal over (i) the meaning of "loss causation" and the application of the loss causation requirement in Section 10(b) cases and (ii) the appropriate measure of damages in Section 10(b) cases. Both of these issues are of considerable significance in litigation under Section 10(b). Because of the different application of the law among the Circuits, Section 10(b) cases could have an entirely different disposition depending on the Circuit where the case was filed. As one commentator has observed, there are "now scores of opinions addressing [causation and] damages under Rule 10b-5" but "[t]his growth of case law . . . has provided few clear answers because a judicial consensus has yet to emerge on major issues." Andrew L. Merritt, *A Consistent Model Of Loss Causation In Securities Fraud Litigation: Suiting The Remedy To The Wrong*, 66 Tex. L. Rev. 469, 481 (1988); *see also In re Washington Pub. Power Sup-*

ply Sys., 650 F. Supp. 1346, 1352 (W.D. Wash. 1986) ("It is apparent from the inconsistencies in the case law that there is some confusion as to the meaning of loss causation.")

Even within the Second Circuit, various panels of the Court have reached conflicting conclusions about the application of the loss causation requirement in Section 10(b) cases. *See, e.g.*, *Marbury Management, Inc.* v. *Kohn*, 629 F.2d 705, 717 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980)), where Judge Meskill filed a dissenting opinion because:

> the majority . . . decision abandons the traditional understanding of causation in the context of the sale of securities induced through misrepresentation, disregards governing precedent and extends the reach of section 10(b) beyond that of its common law antecedent to provide for recovery in cases in which federal policies are offended by such expansion.[6]

The Seventh Circuit—unlike the Second Circuit—has strictly enforced the loss causation requirement in Section 10(b) cases based on a concern that defendants should not be faced with unlimited liability to recompense investors for all losses they may incur:

> No social purpose would be served by encouraging everyone who suffers an investment loss because of an unanticipated change in market conditions to pick through offering memoranda with a fine-tooth comb in the hope of uncovering a misrepresentation. Defrauders

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[6] *See also Schlick* v. *Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974) (recognizing that plaintiffs must show both transaction and loss causation but declining to apply strict causation requirement for pleading an Exchange Act claim), *cert. denied*, 421 U.S. 976 (1975). *Cf. Citibank, N.A.* v. *K-H Corp.*, 968 F.2d 1489, 1495 (2d Cir. 1992) (rejecting plaintiff's contention that it need only establish that the misrepresentation induced the transaction and holding that "plaintiff must show that the economic harm that it suffered occurred as a result of the alleged misrepresentations").

> are a bad lot and should be punished, but Rule 10b-5 does not make them insurers against national economic calamities.

Bastian v. *Petren Resources Corp.*, 892 F.2d 680, 685 (7th Cir.), *cert. denied*, 496 U.S. 906 (1990)); *see also* Point I, *infra* (citing cases).

A provision in the recently enacted Securities Litigation Reform Act of 1995 (the "Reform Act") places on plaintiffs "the burden of proving that the act or omission alleged to violate [Section 10(b)] caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4) (Exchange Act § 210(b)(4)). The Reform Act, which in this regard, merely codifies existing law, provides no guidance on how courts should apply this causation requirement and does nothing to clarify the present state of confusion. For instance, while the Second Circuit has recognized that plaintiffs have the burden of establishing loss causation in Section 10(b) cases, (*see infra* and n.6, *supra*) it has held that the causation component of a Section 10(b) claim is satisfied where plaintiffs demonstrate that the alleged misrepresentation "induced" plaintiffs to buy the securities. *Marbury Management Inc.*, 629 F.2d at 707.

Section 10(b) was never intended to compensate plaintiffs for losses that were caused from factors unrelated to defendants' alleged misrepresentations. Unless plaintiffs are required to prove loss causation in Section 10(b) cases—*i.e.*, that the alleged misrepresentations artificially inflated the market price of their securities—corporations and their directors will be exposed to liability for losses that were caused by general economic and market conditions and the federal securities laws will be used as a blanket insurance policy for investors who are seeking to recoup losses that were unrelated to any violation of the Exchange Act. Contrary to precedent in other Circuits, the Opinion permits a Section 10(b) case to proceed to trial on the claim that a prospectus promised something which did not materialize, even where market evidence

demonstrates that the misstatement did not cause any loss by inflating the market price of the security.

The Opinion also conflicts with numerous decisions construing Section 28(a) of the Exchange Act to prohibit plaintiffs from recovering more than their out-of-pocket losses and is certain to create confusion over when, if ever, a court may deviate from the out-of-pocket rule and disregard Section 28(a).[7] The two cases in which this Court addressed the appropriate measure of damages under the Exchange Act—*Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972), and *Randall* v. *Loftsgaarden*, 478 U.S. 647 (1986)—have been cited for the proposition that the out-of-pocket measure of damages typically applies to claims under Section 10(b). *See* Point II, *infra*.

In connection with the enactment of the Reform Act it was noted that there is substantial confusion among courts over the appropriate measure of damages under Section 10(b) of the Exchange Act:

> The current method of calculating damages in 1934 Act securities fraud cases is complex, with no statutory guidance to provide certainty. As a result, there are often substantial variations in the damages calculated by the defendants and the plaintiffs. . . . The Committee intends to rectify that uncertainty in calculating damages by providing a "bounce back" period, thereby limiting damages to those losses caused by the fraud and not other market conditions.

S. Rep. No. 104-98, 104th Cong., 1st Sess. 19-20 (1995). The Reform Act provides that, in general, plaintiffs in cases such as

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[7] Section 28(a), 15 U.S.C. § 78bb, provides, "no person permitted to maintain a suit for damages under the provisions of this title shall recover . . . a total amount in excess of his actual damages on account of the act complained of." Courts have interpreted Section 28(a) to prohibit a plaintiff from recovering more than his out of pocket losses. *See, e.g.*, *Astor Chauffeured Limousine Co.* v. *Runnfeldt Inv. Corp.*, 910 F.2d 1540, 1551 (7th Cir. 1990).

this are limited to a recovery of the difference between the amount they paid for their securities and the trading price of those securities after corrective disclosure is made. 15 U.S.C. § 78u-4(e) (Exchange Act § 210(3)). The Opinion, however, is contrary to the Reform Act—which was intended to codify existing law—and is likely to perpetuate uncertainty over the circumstances that could warrant a deviation from the "out-of-pocket" rule. Certiorari will also enable this Court to resolve the question which was left unanswered in *Randall* v. *Loftsgaarden:* under what circumstances, if any, may a plaintiff suing under Section 10(b) recover a measure of damages other than his out-of-pocket losses?

* * *

Approximately 300 securities lawsuits are filed each year. S. Rep. No. 98, 104th Cong., 1st Sess. 9 (1995). Many of these cases involve claims under Section 10(b) that are substantially similar to those at issue here, *i.e.*, that the market price of securities was artificially inflated by alleged misrepresentations in disclosure documents. Certiorari in this case will assist the parties and trial courts by providing sorely needed guidance on the critical issues of loss causation and the appropriate measure of damages in Section 10(b) cases.

I. THE SECOND CIRCUIT'S RULING CONFLICTS WITH DECISIONS IN THE FIFTH, SEVENTH, NINTH AND ELEVENTH CIRCUITS HOLDING THAT DAMAGES CANNOT BE RECOVERED UNDER SECTION 10(b) OF THE EXCHANGE ACT IN THE ABSENCE OF LOSS CAUSATION

The District Court expressly held that the market price of plaintiffs' Debentures declined long before the "corrective" disclosure and plaintiffs conceded that this price decline was caused by the issuer's deteriorating financial condition and the stock market crash of October 1987. App., *infra*, 19a-20a,

36a. Damages cannot be recovered under Section 10(b) of the Exchange Act where, as here, the value of the securities declines before corrective disclosure is made because such losses could not possibly have been caused by the as-yet-undiscovered fraud. As the Seventh Circuit explained in *Harris Trust & Sav. Bank* v. *Ellis*, 810 F.2d 700, 706 (7th Cir. 1987):

> Causation is an essential ingredient of any securities case. In an action under § 10(b), the plaintiff cannot take advantage of the rescissionary remedies provided elsewhere in the securities laws. *Cf. Randall* v. *Loftsgaarden*, ___ U.S. ___, 106 S. Ct. 3143, 92 L. Ed. 2d 525 (1986). If, for example, a firm reveals that an earlier public statement was mistaken, but the price of the securities does not move in response, the investors suffer no damages. The plaintiff must prove damages, must establish the difference between the price received in fact and the price that would have been received but for the fraud. *See Mills* v. *Electric Auto-Lite Co.*, 552 F.2d 1239 (7th Cir.), *cert. denied*, 434 U.S. 922, 98 S. Ct. 398, 54 L. Ed. 2d 279 (1977) (dismissing a securities case, despite an earlier holding by the Supreme Court that fraud had occurred, on the ground that the plaintiff could not establish that in the absence of the fraud he would have received a greater price).

The Fifth, Ninth and Eleventh, like the Seventh Circuit, have held that the absence of any causal connection between the alleged misrepresentation and the decline in value of plaintiffs' securities is an absolute bar to recovery under Section 10(b). For instance, the Fifth Circuit explained in *Huddleston* v. *Herman & MacLean*, 640 F.2d 534 (5th Cir. 1981), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983):

> The plaintiff must prove not only that, had he known the truth, he would not have acted, but in addition that the

> untruth was in some reasonably direct, or proximate, way responsible for his loss. *The causation requirement is satisfied in a Rule 10b-5 case only if the misrepresentation touches upon the reasons for the investment's decline in value. If the investment decision is induced by misstatements or omissions that are material and that were relied on by the claimant, but are not the proximate reason for his pecuniary loss, recovery under the Rule is not permitted.* Absent the requirement of causation, Rule 10b-5 would become an insurance plan for the cost of every security purchased in reliance upon a material misstatement or omission.

640 F.2d at 549 (emphasis added) (citations and footnote omitted).

In *McGonigle* v. *Combs*, 968 F.2d 810, 819 (9th Cir.), *cert. dismissed*, 506 U.S. 948 (1992), the Ninth Circuit affirmed a directed verdict and held that "[t]he plaintiff must also establish loss causation, and that means that the misrepresentations and omissions have to have caused the harm, that is, they have to have impacted the value of the investment." *See also Bruschi* v. *Brown*, 876 F.2d 1526, 1530 (11th Cir. 1989) ("even though the defendant's misconduct induces the plaintiff to make the investment, if the particular loss complained of is caused by supervening general market forces or other factors unrelated to the defendant's misconduct that operate to reduce the value of plaintiff's securities, the plaintiff is precluded from recovery under Rule 10b-5").[8]

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[8] In *Bastian* v. *Petren Resources Corp.*, 892 F.2d 680 (7th Cir.), *cert. denied*, 496 U.S. 906 (1990), Judge Posner vigorously criticized the plaintiffs' attempt to recover under Section 10(b) for their lost investment where the cause of the loss was actually a result of the collapse of the oil and gas market and not the misrepresentations alleged to have been made in the offering memorandum. The court also stated that "any award of damages to them would be a windfall." *Id.* at 684-85; *see also Currie* v. *Cayman Resources Corp.*, 835 F.2d 780, 785 (11th Cir. 1988) ("Loss causation requires a showing that the 'misrepresentations or omissions caused the economic harm. . . .' In other words, a plaintiff must demon-

Although the Second Circuit Opinion recognized that in the context of a Section 11 claim under the Securities Act, "a price decline before [corrective] disclosure may not be charged to defendants" (App., *infra*, 11a), it failed to address decisions holding that such evidence is equally fatal to plaintiffs' Section 10(b) claim. *See, e.g., Bastian*, 892 F.2d at 684-86. Instead, the Second Circuit summarily stated that "plaintiffs' Section 10(b) claim stands on a different footing." App., *infra*, 11a. In fact, if this case had arisen in the Fifth, Seventh, Ninth or Eleventh Circuits, the same evidence that required the dismissal of plaintiffs' Section 11 claim would also require the dismissal of their Section 10(b) claim.

In sum, the Second Circuit's ruling conflicts with decisions in other Circuits and essentially makes Section 10(b) an insurance plan for every plaintiff who purchases securities based upon a misrepresentation without regard to whether the misrepresentation in fact caused any loss to plaintiff.

II. THE SECOND CIRCUIT'S RULING CONFLICTS WITH THE DECISIONS OF THIS COURT AND OTHER CIRCUITS HOLDING THAT UNDER SECTION 10(b) OF THE SECURITIES EXCHANGE ACT PLAINTIFFS ARE LIMITED TO A RECOVERY OF THEIR OUT OF POCKET LOSSES AND MAY NOT RECOVER "EXPECTATION" BASED DAMAGES

The Second Circuit's ruling permits plaintiffs to recover a contractual measure of damages—benefit-of-the-bargain—under Section 10(b) of the Exchange Act. This Court has previously recognized, however, that plaintiffs in Section 10(b) cases are customarily limited to an out-of-pocket measure and that this rule is intended to compensate plaintiffs for losses caused by the defendant's fraud. *See Affiliate Ute Citizens* v. *United States*, 406 U.S. 128, 155 (1972) (holding that "the

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strate that the defendant's fraudulent conduct 'touches upon the reasons for the investment's decline in value.' " (citations omitted)).

correct measure of damages under Section 28 of the Act, 15 U.S.C. § 78bb(a), is the difference between the fair value of all that [the plaintiff] received and the fair value of what he would have received had there been no fraudulent conduct"); *see also Randall* v. *Loftsgaarden*, 478 U.S. 647, 688 (1986) (recognizing that, typically, "the proper measure of damages in a § 10(b) case is an investor's out-of-pocket loss"). The out-of-pocket measure of damages excludes losses due to the subsequent change in the market unrelated to the misrepresentation or omission, on the basis that the investor assumes the risk of general market fluctuation, and may be compensated only for damages proximately caused by the material misrepresentation or omission. *See Sharp* v. *Coopers & Lybrand*, 649 F.2d 175, 189-91 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982).

Affiliate Ute and *Randall* have been construed by the Seventh, Third and Sixth Circuits to limit defrauded buyers of securities to a recovery of their actual losses. For example, in *Astor Chauffeured Limousine Co.* v. *Runnfeldt Inv. Corp.*, 910 F.2d 1540, 1551-1552 (7th Cir. 1990), the court held:

> The federal securities laws allow victims of fraud to recover their actual loss—the difference between what they paid for the stock and what it was worth. . . . Hence the maximum recovery in the case of fraud influencing a purchase is the purchase price, a limit §§ 11 and 12 of the '33 Act make explicit and that § 28 of the '34 Act strongly implies. . . . At all events, the statutes limit victims to "actual damage," which courts routinely understand to mean "out of pocket loss."
>
> Securities generally have no "bargain element"; the price is what they are worth. . . . [plaintiff] cast this as a securities transaction, and it gets the securities measure of damages.

See also Hoxworth v. *Blinder, Robinson & Co.*, 903 F.2d 186, 203 n.25 (3d Cir. 1989) ("Although the Supreme Court has

reserved the question whether a rescissory measure of damages is ever appropriate for defrauded buyers under Rule 10b-5, this court has expressed clear disapproval of a damage theory that would insure defrauded buyers against downside market risk unrelated to the fraud, which is exactly what a rescissory measure is designed to accomplish") (citations omitted).

The Sixth Circuit recently reversed a damage award in a Section 10(b) case because the trial court failed to apply an "out-of-pocket" measure of damages:

> Out-of-pocket damages, the alternative to rescissory damages, are not expectancy damages. . . . expectancy damages—damages designed to give the plaintiff the benefit of his bargain—are simply not recoverable under the federal securities laws.

Stone v. *Kirk*, 8 F.3d 1079, 1093 (6th Cir. 1993).

Although *Levine* v. *Seilon Inc.*, 439 F.2d 328 (2d Cir. 1971) (Friendly, J.), made clear that benefit-of-the-bargain damages may not be awarded under the Exchange Act,[9] the Opinion characterizes Judge Friendly's ruling in *Levine* as "dicta" (App., *infra*, 12a) and permits plaintiffs to seek a windfall recovery of approximately *twice* the amount that they paid for their securities. The Second Circuit Opinion replaces the general rule that only out-of-pocket damages can be awarded on a Section 10(b) claim with a remedy that, heretofore, no other Circuit Court has applied to a Section 10(b) claim in a case involving the purchase of securities. The Opinion does not cite to any other case in which a defrauded buyer of securities has been permitted to recover benefit-of-the-bargain damages

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[9] *See Levine*, 439 F.2d at 334 (holding that a "defrauded buyer of securities is entitled to recover only the excess of what he paid over what he got, not as some other courts have held, the difference between the value of what he got and what it was represented he would be getting"); *see also Zeller* v. *Bogue Elec. Mfg. Corp.*, 476 F.2d 795, 801-02 (2d Cir.) (Friendly, J.) ("the thrust . . . of what we said . . . in *Levine* was to repudiate the 'benefit-of-the-bargain' rule in cases arising under the Securities Exchange Act"), *cert. denied*, 414 U.S. 908 (1973).

under the Exchange Act and there appears to be no such authority in the Circuit Courts of Appeal. *See, e.g.*, Frank H. Easterbrook and Daniel R. Fischel, *Optional Damages in Securities Cases*, 52 U. Chi. L. Rev. 611, 630 (1985) ("With exceptions so rare as to be practically unimportant, courts do not award benefit-of-the-bargain damages . . . in securities cases.")

The only other case in which the Second Circuit permitted a plaintiff to seek benefit-of-the-bargain damages, *Osofsky* v. *Zipf*, 645 F.2d 107 (2d Cir. 1981), involved a Section 14(a) claim under the Exchange Act by allegedly defrauded *sellers* of securities. The holding in that case was limited expressly to actions involving tender offers or mergers: "the benefit-of-the-bargain rule should be applied under the 1934 Act to the limited situation involved in this case, where misrepresentation is made in the tender offer and proxy solicitation materials as to the consideration to be forthcoming upon an intended merger." *Id.* at 114.[10]

In contrast to the tender offer or merger situations where plaintiff has been promised a sum certain for his or her shares, the Opinion permits plaintiffs to recover a contractual measure of damages based on their mere expectation that the poison put provision in the Indenture would have been triggered if Wherehouse's Independent Directors had not approved the Merger and assuming that the acquisition would then have been completed on a hostile basis. To allow this contractual "expectation" measure of damages will be to thrust juries into a world of complete speculation and is also entirely inconsistent with both the loss causation requirement and the prior decisions of this Court limiting defrauded purchasers of securities to a recovery of their out-of-pocket losses in Section 10(b) cases.

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[10] *See also Barrows* v. *Forest Lab., Inc.*, 742 F.2d 54 (2d Cir. 1984) (recognizing that application of the benefit-of-the-bargain damage formula has been strictly limited to cases involving tender offers or mergers where the plaintiff *sells* or *exchanges* his securities for a promised amount of consideration).

CONCLUSION

For the reasons stated above, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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